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# External Trade Diversion, Exclusion Incentives and the Nature of Preferential Trade Agreements\*

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## Abstract

In a game of endogenous trade agreements between three countries, we show that while the pursuit of customs unions (CUs) prevents global free trade from emerging as a coalition-proof Nash equilibrium, the pursuit of free trade agreements (FTAs) does not. This result reflects the relatively *flexible* nature of FTAs: whereas each FTA member can independently undertake further trade liberalization with respect to the non-member, CU members must do so as a group due to their common external tariff. By diverting members' exports away from the non-member, both types of trade agreements induce the non-member to voluntarily lower its import tariffs.

*Keywords:* Free Trade Agreement, Customs Union, Hub and Spoke Agreements, Free Trade, Optimal Tariffs. *JEL Classifications:* F11, F12.

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